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SIPDIS

SENSATIVE

STATE FOR EUR PDAS RIES, EB, EUR/AGS, AND EUR/ERA  
STATE PASS FEDERAL RESERVE BOARD  
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TREASURY FOR DAS LEE  
TREASURY ALSO FOR ICN COX, HULL  
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E.O. 12958: N/A

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SUBJECT: International Use of the Euro - Broadly Stable;  
Some Increase In Euro Trade Invoicing

T-IA-F-05-0006

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Internet distribution.

1. (SBU) Summary: The European Central Bank's (ECB) annual publication on the international role of the Euro concludes that the euro's role in international capital and foreign exchange markets and use as an international reserve currency "has remained largely stable," while "there have been signs of increasing use" of the euro for settling or invoicing trade. This rather unexceptional conclusion, akin to a "dog bites man," story sharply contrasts to the attention-grabbing headlines "Central Banks Shunning Dollar," proclaiming that a survey of central banks revealed many had increased their euro exposure. The survey, however, was only "impressionistic," in the ECB's assessment and did not provide any hard data documenting any increases.
2. (SBU) Notable features of the ECB's report are that:  
(a) the Euro's share of official exchange reserves increased slightly, from 19.3% in 2002 to 19.7% in 2003, nearly two-thirds of the increase in euro holdings was due to an increase in the euro's price in relation to special drawing rights (SDRs); (b) the share of exports and imports invoiced or settled in euros has increased in trade with countries outside the euro area; and (c) the euro denominated international debt securities market remains robust, with the stock of euro international debt instruments holding a steady 31% market share. The ECB's report identifies merger and acquisition activities and firms' strategic objective to broaden their investor base as main reasons for firms, including many from the US, using the euro international bond market. End Summary.

#### International Role of the Euro

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3. (SBU) Each year the ECB publishes a report tracking the international use of the euro. This year's report, published in January 2005, covers the period mid-2003 to mid-2004. The ECB's policy is not to encourage the use of the euro outside the euro area, but considers developments in the use of the euro as "the outcome of decisions taken by market participants." The ECB's success in maintaining the value of the euro contributes to market participants' perception of the euro, particularly as a store of value.
4. (SBU) Since its introduction the euro quickly assumed the role of its legacy currencies in finance and trade. With the advent of one currency in the euro area, at a stroke its capital markets were broadened and deepened, at least in theory. Some accession candidate countries, now the new member states, pegged their currencies to the euro, increased their trade with euro area businesses, and, when the euro cash conversion occurred, saw savers convert their holdings of Deutsche Marks to euro bank accounts. Earlier ECB reports document this one time shift.
5. (SBU) This year's report suggests that after the first rush of conversions, activity has become less dramatic. Broadly speaking, the report shows a "significant degree of stability" in the use of the euro by non-euro area residents. There is some evidence that the euro is increasingly being used in settling or invoicing trades with non-euro area countries in neighboring regions, although some of the shift could be an improvement in data collection by national authorities.

#### International Reserve Currency

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6. (SBU) Global reserve assets totaled USD 3, 014 billion as of the end of 2003, an increase of 26% from the previous

year. The share of euro-denominated assets of total foreign exchange reserves edged up from 19.3% to 19.7% over this same time period, driven by an increase in euro-denominated holdings in developing/emerging market countries (17.9% to 18.9% share). The share of euro-denominated foreign exchange reserves of industrial countries' total reserve assets declined from 21.3% to 20.9%. The share of USD denominated foreign exchange reserves rose slightly, from 63.5% to 63.8%.

17. (SBU) One interesting feature was the role that price changes played during the recent reporting period. The International Monetary Fund (IMF) tallies foreign exchange reserves in special drawing rights (SDRs), whose value is derived from a basket of currencies. Therefore, when a currency appreciates against the SDR, the SDR price of assets denominated in that currency also rise. In 2003 the amount of euros in official holdings of foreign exchange increased by 55 billion SDRs, but 34 billion of the increase was due to a price change. This reflects the euro appreciation and, according to ECB experts, the large stock of euro-denominated foreign assets being held as reserves.

18. (SBU) The ECB report notes that the amount of USDs in official holdings of foreign exchange increased by 161 billion SDRs. The increase in quantity (263 billion SDRs) more than compensated for the decrease in price (-102 SDRs). This large increase in USD denominated holdings reflects, in part, macro economic strategy by some Asian countries, according to ECB staff, to maintain a stable exchange rate. An October 2004 publication of the New York Federal Reserve Bank surmises, "The largest USD reserve purchases likely came from Japan, China and Taiwan, with India and Korea also making sizable purchases."

19. (SBU) This relatively mundane picture is contrary to the attention-grabbing headlines on January 23 proclaiming that central banks are "shunning the US dollar." Those headlines were prompted (or promoted?) by a survey conducted by Central Banking Publications. The survey proclaimed that 39 of 65 central banks were raising their euro holdings and 29 were reducing their dollar holdings.

110. (SBU) ECB staff, surprised by the report (and summoned to brief ECB President Trichet), examined it carefully. The survey results were "impressionistic," in their view, based on one question: "Have you increased or decreased exposure to a certain currency?" The survey did not contain any more recent information or hard data and reflected views of a wide range of banks, from very small to some very large, although the largest Asian central banks did not respond to the questionnaire, in the ECB staff's assessment. The ECB relies on IMF data to calculate reserves and does not collect its own information from central banks.

#### Trade :Invoicing and Settling

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11. (SBU) The ECB report notes that the share of the use of euro to settle or invoice trades for exports and imports outside the euro area has increased, more so for goods than for services. Most dramatic among the increases has been for Germany, which had 63% of its exports invoiced/settled in euros in 2003 compared to 49% in 2002, and 55% of its imports invoiced/settled in euros in 2003 up from 48% the previous year.

112. (SBU) Germany, France, Italy and Spain all had more than 50% of their exports settled/invoiced in euro while only Germany and Spain had more than 50% of their imports settled in euro. ECB staff observes that this result reflects "Grassman's Law" whereby "exporters are typically in a better position to enforce their currency preferences" than importers. Of the new member states, the Czech Republic, Estonia, Latvia, Poland and Slovenia all had more than half their exports invoiced/settled in euros (no data for Malta and Slovakia). Candidate countries Bulgaria and Romania have better than 60% of their exports invoiced/settled in euros.

113. (SBU) Reasons for the increase are partially due to new data. The ECB relies on national authorities for this data, some of which has become available only recently. ECB staff also suspects valuation has contributed to the increase as well as long-term contracts that had been in legacy currencies and are now being renewed in euros. The ECB report notes that the use of the euro in trade is geographically concentrated in countries neighboring the euro area, but also detects "some evidence" of an increase use in other countries. There is, however, a natural ceiling to the use of euros in trade, particularly import transactions, as certain commodities that are traded on exchanges or referenced priced in USD, such as oil.

114. (SBU) A recent staff paper of the New York Federal Reserve Bank broadly confirms the ECB's findings. It states that the USD is "strongly used on all trade transactions

with the United States and on other transactions that are primarily in goods that are traded on organized exchanges or that are referenced priced." The staff paper reports that USD invoicing accounts for more than 50% of exports and imports in the Asian countries of Japan, Korea, Malaysia and Thailand as well as Australia. Greece was the lone euro area country in this category, most likely due to the predominance of maritime shipping in its trade. However, the NY Fed paper notes that the share of exports and imports of goods that are traded on organized exchanges or reference priced has declined as trade in manufactures has increased. Thus, the paper concludes that these declines suggest that there has been a steady decline in USD invoicing via this channel.

#### Debt Securities

15. (SBU) The ECB uses a narrow definition of international securities, referring to issuance in a currency other than the currency of the country in which the borrower resides. Using this measure, the stock of outstanding international debt securities is USD 5,042 billion, 31% of which are denominated in euros, 42% in USDs. These shares have been steady for the last few years, after the euro legacy currency share climbed quickly after its introduction in 1999, gaining nearly 10% in market share by 2001 while the USD share eased 2%. Using a "global measure" of debt securities that includes securities denominated in the home currency and targets the international and domestic market shows that the USD account for 43% of USD 53,000 billion in outstanding debt securities while the euro accounts for 25.6%.
16. (SBU) The ECB explains in another report on the euro bond market reasons for the rapid gains of the issuance of euro denominated international debt securities. It explains this development as a product of efficiency gains brought about by the growing size of the euro area financial markets, supported by the creation of payment and security settlement systems and a unified money market, as well as increased competition from non-euro area underwriters that drove down underwriting fees. In a special section of this year's report, the ECB analyzes in detail the issuance activity by private entities and concludes that is it often associated with merger and acquisition activity or with the strategic objective of broadening the investor base.
17. (SBU) The largest issuers in this market are European entities, especially UK firms, accounting for 44% of the total in outstanding international debt instruments. US residents account for about 20% of the issuance activity. Large issuers from the United States include Federal Home Loan Mortgage (Freddie Mac), Merrill Lynch, Goldman Sachs, General Motors Acceptance Corporation and GE Capital. On average, around 80% of these debt issues are initially purchased by European investors.

#### Foreign Exchange

18. (SBU) According to the 2004 Triennial Survey conducted by the Bank of International Settlements, the euro was involved in 37% of all foreign exchange transactions in 2004, a decrease of less than one percentage point compared to its share in 2001. Average daily turnover in the forex market is estimated to be USD 1,880 billion. 76% of all global activity involving the euro was in trading vis--vis the USD.

#### Use As Parallel Currency

19. (SBU) Residents in some countries outside the euro area hold assets in euro denominated assets, mostly as cash or euro denominated bank accounts. In countries neighboring the euro area, foreign cash held in legacy currencies, predominately Deutsche Marks, had been converted into euro cash notes or deposits. By the end of 2002, two years after the conversion to euro cash notes, the flow of euro banknotes shipped to destinations outside the euro area has stabilized. Net shipments of euro banknotes to destinations outside the euro area amounted to euro 9.4 billion down from euro 14.2 billion in the previous year. The cumulative stock of euro banknotes outside the euro area was euro 45.8 billion by the end of June 2004 compared to euro 36.4 billion a year earlier.
20. (SBU) The ECB's data showed that Russian businesses and households demand euro cash for conducting trade and tourism. However, when some Russian banks faced liquidity problems in mid-2004, depositors preferred to exchange their ruble deposits into USD cash.
21. (SBU) The nations of the former Yugoslavia have a

significant share of bank deposits denominated in euro. In Croatia, Macedonia, Montenegro and Serbia better than half of the total bank deposits are denominated in euros. Interestingly, the new member states have a much smaller share of euro-denominated deposits with the highest in Latvia, at 19.8%. This suggests that new member states have more credible monetary policy that protects the value of their local currency. ECB experts point out that conducting monetary policy is rendered more difficult when a large share of deposits are denominated in foreign currency.

122. (U) This message coordinated with Embassies Berlin, and USEU Brussels.

123. (U) POC: James Wallar, Treasury Representative, e-mail wallarjg2@state.gov; tel. 49-(69)-7535-2431, fax 49-(69)-7535-2238

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